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Recovery Is Hesitant and Uneven but Should Pick Up Gradually, Says *WEO*

Global economic recovery from the 1991 downturn is continuing but is less than robust, according to the IMF staff's latest *World Economic Outlook (WEO)*. Although some industrial countries have emerged from recession, growth rates have declined in many other countries. Consequently, the growth rate of world output increased only modestly from ½ of 1 percent in 1991 to 1¾ percent in 1992. The report predicts that the recovery will continue to strengthen, with world output growth increasing to 2¼ percent in 1993 and 3½ percent in 1994, but cautions that the outlook "remains unusually uncertain."

The just-published report, which was issued to the press in unpublished form shortly before the recent spring meetings of the Interim and Development Committees and contains statistical data as of April 14, notes that one encouraging development has been the continued easing of inflation in most industrial and developing countries. Another has been stronger growth in the United States and Canada.

Among the principal obstacles to global recovery are the recent marked deteriorations in the economic performances of Japan and, especially, Europe, which is expected to remain in recession for much of 1993. The IMF staff, which cut its 1993 economic growth rate forecast for Japan from 3¾ percent in the October 1992 *WEO* to 1¼ percent in the current one, cites the effects of balance sheet adjustments by households, corporations, and financial institutions after the recent correction of inflated asset prices (e.g., in equity and real estate markets) as principal reasons for the country's darkened near-term prospects. Its 1993 growth forecast for Europe was changed from 2¼ percent in the October *WEO* to stagnation (essentially zero growth) in the current one, largely because of tight monetary conditions, inadequate progress toward inflation convergence in many countries, and the attendant weakness of consumer and business confidence.

Michael Mussa, the IMF's Research Director, oversaw the WEO's preparation.

Meanwhile, many developing countries have continued to turn in comparatively strong *(continued on page 162)*

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Economic Outlook Is Unusually Uncertain

(continued from front page) economic performances in the face of weak economic activity in industrial countries. For many other developing countries, though, economic growth has been unsatisfactorily low, with the result that living standards have continued to decline in many of the poorest countries, especially those in sub-Saharan Africa. The countries in transition from central planning continue to face serious economic problems, according to the *WEO*, in view of the sharp declines in their output. It notes, however, that recessions in parts of central Europe appear to have bottomed out, and positive growth rates are expected for some in 1993 and 1994.

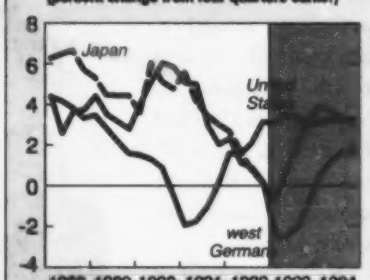
"Notwithstanding the continued economic difficulties in many countries," the report states, "recent positive developments offer hope for a cooperative growth strategy in the near term, which could permit a strengthening of global economic performance over the medium term."

Industrial Countries

Many industrial countries' current economic difficulties owe much to the failure to adopt key elements of the medium-term strategy they worked out in the early 1980s to guide their economic policies. In particular, their inadequate efforts to control budgets and eliminate structural rigidities in their economies, the report observes, "have left countries in a weak position to cope with the recent—and continuing—sluggishness of global economic activity." Large budget deficits have contributed to high long-term real interest rates (that is, interest rates net of inflation) and have been an important cause of the recent turbulence in European foreign exchange markets. Labor market policies, especially in Europe, have not successfully been adapted to cope with persistently high unemployment. Further, the report notes, many countries continue to suffer the adverse effects of asset deflation brought about by the tightening of monetary policies that followed the speculative excesses in asset markets of the late 1980s.

Three Major Industrial Countries: Real GDP, 1988–94[1]

(percent change from four quarters earlier)



[1]Blue shaded area indicates staff projections.

Data: IMF, *World Economic Outlook*, May 1993

The *WEO* asserts that the industrial countries "now need to take effective action to strengthen growth and to diminish exchange and financial market tensions while preserving progress in reducing inflation." It also comments that conditions in Europe are improving enough to permit "significant reductions of official interest rates, which should help to contain recessionary forces and ensure that recovery takes hold by 1994."

For the United States, according to the report, the highest priorities of economic policy should be to reduce the large federal budget deficit and strengthen saving and investment. It calls the administration's February 1993 economic plan "a considerable effort" to reduce the deficit but cautions that "further action is needed to ensure an adequate degree of fiscal consolidation over the medium term." The *WEO* also comments that "significant short-term stimulus is now less necessary than might have appeared earlier."

In Japan, the report states, "while there are recent signs of a bottoming out of the recession, uncertainties remain with respect to the timing and strength of the upswing." To ensure that the economy gains adequate momentum, the Japanese authorities have recently reinforced the package of stimulative fiscal measures they announced in August 1992 with a substantial package that supplements the budget for fiscal year 1993 (April 1993–March 1994). The *WEO* expresses the view that "given Japan's efforts at fiscal consolidation in the past, these measures do not jeopardize the credibility of the authorities' medium-term budgetary objectives." It goes on to state that "the low inflation rate and the recent strength of the yen suggest that there remains some room for interest rate reduction should economic weakness persist."

The *World Economic Outlook* asserts that "in Europe, an essential contribution to stronger growth would come from a further reduction of interest rates in Germany as the inflationary consequences of unification fade." It cites indications that Germany's inflation should soon begin to moderate, thereby facilitating interest rate reductions. It also comments that "progress toward fiscal consolidation, which would need to go beyond the recent solidarity pact, would also contribute to the reduction of macroeconomic imbalances."

READEX FICHE

Commenting on the recent exchange crisis in the European Monetary System (EMS), which was touched off in September 1992, the report states that the direction of each of the exchange rate changes that has subsequently taken place has been consistent with the economic fundamentals. It adds, however, that "for some currencies . . . the large depreciations appear to have overshot, which is adding to strains in economic relations within Europe." It continues, "although the pressures on the system have abated since early February, economic policy cooperation within the EMS will need to be strengthened to reduce the risk of a recurrence of turbulence and to promote further progress toward economic and monetary union (EMU). A key requirement remains the need to ensure greater economic convergence."

In particular, the report emphasizes the importance of strengthening monetary policy cooperation throughout Europe. On this point, it comments that "economic and financial integration is rapidly eroding the distinction between resident and nonresident enterprises and financial institutions and appears to be blurring the distinction between national monetary indicators." It suggests that "it will therefore be necessary to consider whether—and how—national indicators of monetary conditions, activity, and inflation might be complemented with ERM-wide [referring to the exchange rate mechanism of the EMS] indicators."

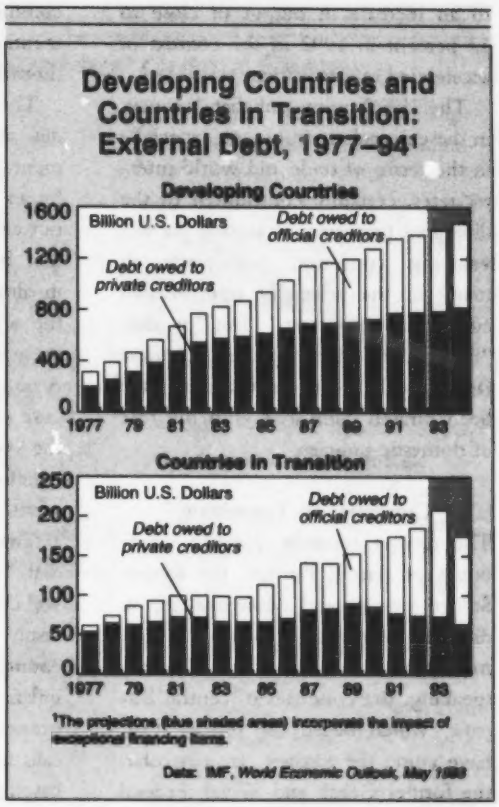
The *World Economic Outlook* stresses the importance of complementary economic policies in industrial countries if satisfactory growth is to be achieved in 1993 and beyond. It also emphasizes that "sustained expansion in each of the major industrial countries benefits from, and to an important extent requires, sustained expansion in its partner countries."

Developing Countries

The *World Economic Outlook* projects annual economic growth in developing countries at 5 percent in 1993 and 1994, only slightly below the 1992 rate of 6 percent—the highest in more than a decade. "As more countries implement stabilization and structural reform policies," it observes, "the medium-term prospects for the developing world appear brighter than they have been for some time." At the same time, however, it acknowledges that developing countries' growth rates have diverged in recent years.

The report notes that the stronger performers among the developing countries share a number of characteristics. Compared with the slower-growing countries, they have considerably higher saving rates, higher investment rates (including for investment in human capital), higher efficiency of investment, and higher overall productivity growth. The more successful developing countries typically finance a larger proportion of investment with domestic savings, and when they draw on foreign savings, they prefer foreign direct and portfolio investment to debt-creating capital inflows (such as those they obtain by borrowing from commercial banks). In addition, these countries are generally more outward-oriented, with respect both to trade links with the industrial countries and to their economic ties with other developing countries.

The stronger performers, according to the report, have generally maintained or restored sustainable fiscal balances, low and predictable inflation, positive but low real interest rates, viable balance of payments positions, and competitive (as opposed to overvalued) and stable exchange rates. In addition to maintaining their macroeconomic stability, these countries have relied on market forces to allocate resources efficiently, reduced government intervention, fostered trade liberalization and currency convertibility, and encouraged financial market reform. According to the *WEO*, "the impressive growth record of many Asian countries illustrates the longer-term benefits from sustained stabilization and reform efforts, and the recent experience of many Latin American countries demonstrates that economic growth can recover when the necessary policies are put in place." It also notes that in China, strong demand pressures led



to an increase in output of close to 13 percent in 1992 in the context of accelerated reform efforts.

The *WEO* points out that "changes in the external environment, especially in the terms of trade and world interest rates, certainly contributed to the divergent performance among the developing countries, particularly in many of the relatively undiversified commodity exporters." "But," it adds, "in most countries the effects of these factors on long-run performance have been limited compared with the role of domestic policies."

Countries in Transition

The former centrally planned economies of central Europe, the former Soviet Union, and Mongolia are in different stages of the transition to market-based economies. Broadly speaking, the countries of central Europe, which began the process first, have come the furthest. In particular, the former Czech and Slovak Federal Republic, Estonia, Hungary, Latvia, and Poland have made significant progress in achieving macroeconomic stabilization. The *WEO* notes, though, that most countries "still face difficult fiscal problems stemming from the web of soft budget constraints and state subsidies, increases in outlays for social benefits and structural reform, or reductions in revenues because of output declines and administrative difficulties."

The *WEO* comments that a disturbing development in 1992 among central European countries was the emergence or continuation of considerable strains on government budgets. It notes that a principal cause of this problem has been the dramatic decline of tax revenue—especially from turnover and business-profits taxes—caused by sharp declines in output. It points out that new taxes, including value-added taxes (VATs), have been introduced but comments that difficulties in implementing them have led to revenue shortfalls.

The report observes that "the sudden and pronounced fall in government revenue has not been matched by an equal drop in public spending, notwithstanding the substantial cuts that have already been implemented in almost all countries. Moreover, as the adjustment process proceeds, new pressures on expenditures will arise." Among other things, it suggests that state enterprises need to shift more of the responsibility for providing social benefits, including unemployment insurance, to governments.

The *World Economic Outlook* warns that "large and rising budget deficits will crowd out private investment, may result in deterioration in current accounts, and could lead to accelerating inflation, thereby threatening macroeconomic stability." It consequently calls for new taxes, broadening of tax bases, improved tax administration, further reductions in subsidies, and redoubled efforts to contain government expenditures. Almost all countries in central Europe, the report notes, have sought to reduce demands made on their budgets for the support of loss-making state enterprises by launching ambitious privatization programs. It comments that "progress has generally been slower than expected" but adds that, substantively, "the experience with privatization has so far been encouraging."

Output in the former Soviet Union has declined sharply over the past two years and is expected to decline further in 1993. Meanwhile, inflation has risen rapidly and is likely to remain quite high in 1993. The report suggests, however, that "if macroeconomic stability can be achieved, and if the economic reform programs are followed through, most of the countries in the former Soviet Union could experience sharply falling inflation during 1993 and an economic turnaround as early as the middle of the next decade."

An important cause of the inflationary pressure in the states of the former U.S.S.R. has been excessive credit expansion by central banks to state enterprises. Another has been the monetization of the large budget deficits run up by many of these countries. Other important causes, according to the report, include "the explosion of inter-enterprise arrears and chaotic monetary relations in the ruble area." The report notes that "the shortage of currency and the blockage of the interrepublican settlement system have led to a de facto dissolution of the ruble area" and asserts that "an orderly withdrawal from a common currency structure is likely to be less disruptive than remaining in a dysfunctional monetary union."

Trade Policies

The report comments that the failure to conclude the Uruguay Round of multilateral trade negotiations is adding to global trade tensions and "depriving the world of potentially large gains from further liberalization of tariff and nontariff barriers; from the extension of multilateral rules to new sectors; from a strengthening of rules and disciplines on antidumping, subsidies, and safeguards; and from a strengthening of the dispute settlement mechanism and of trade policy surveillance."

The English edition of the *World Economic Outlook, May 1993* has just been published, and the Arabic, French, and Spanish editions will be published by mid-June. Copies of each edition cost US$30.00 (US$20.00 for full-time faculty members and students at universities and colleges) from Publication Services, Box S-371, International Monetary Fund, Washington, DC 20431, U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201.

WEO Changes Method of Calculating Countries' Output Shares

Measures of the growth of the world economy reported in the *World Economic Outlook (WEO)* are weighted averages of the growth of individual countries. To calculate such weights, a country's gross domestic product (GDP)—which is, by definition, measured in its own currency—needs to be converted into a common currency. Traditionally, the IMF's *World Economic Outlook* team has converted each country's GDP into U.S. dollars using market exchange rates. Since these weights may inaccurately reflect countries' relative economic sizes, the IMF has decided, beginning with the current issue of the report, to use estimates based on purchasing power parity (PPP) in computing these weights.

While a market exchange rate shows how much of one country's currency—for example, China's yuan—must be paid for a specific amount of another country's currency—for example, US$1—on foreign exchange markets, it may not correspond to the ratio of the quantities of yuan and U.S. dollars required to purchase equivalent baskets of goods and services in China and the United States, respectively. Purchasing power parity, however, provides an alternative method of valuing different currencies by comparing their actual domestic buying power in this way.

Annex IV of the *WEO* states that "market rates may be distorted by speculative bubbles, exchange market intervention, asymmetric speed of adjustment in goods and asset markets, or macroeconomic shocks. . . . In the case of developing countries, market exchange rates may deviate from their PPP values because of differences [between the two countries] in the relative price of traded versus nontraded output. For example, the price of services in developing countries is typically very low in foreign currency terms, and this implies a negative bias in exchange-rate-based estimates of living standards." It adds that in some countries, market-determined exchange rates do not even exist, making it doubtful that such exchange rates as do exist are accurate indicators of the currencies' value.

The IMF has introduced PPP-based weights into its *WEO* calculations in an effort "to obtain a more accurate measure of the relative sizes of economies." The most important effect of the change from exchange-rate-based weights to PPP-based weights has been the substantially increased share of world output accounted for by the developing countries—from 18 percent to 34 percent—and the corresponding decreased share accounted for by the industrial countries—from 73 percent to 54 percent. The PPP-based weights are derived from PPP estimates of GDP from the International Comparison Program (ICP), supplemented by World Bank and IMF staff estimates for the countries not covered by the ICP and for China.

The *WEO* notes that "the PPP-based weights also imply somewhat stronger growth of the world economy—an average of almost ⅓ of 1 percent a year over the 1983–92 period—reflecting generally faster growth in the developing countries than in the industrial countries."

The report also states that while there is a broad consensus in the economic profession about the appropriateness of using PPP-based weights to aggregate figures for individual country output and some other economic indicators, it would not be appropriate to use them for measuring such things as international trade and capital movements.

World Output Shares Compared: Exchange-Rate-Based Weights vs. PPP-Based Weights[1]

(percent of world GDP)

	Exchange-Rate-Based Weights	PPP-Based Weights
World	100.00	100.00
Industrial countries	73.21	54.44
Major industrial countries	63.08	46.86
United States	26.07	22.47
Japan	14.61	7.63
Germany[2]	6.23	4.26
France	4.99	3.50
Italy	4.36	3.39
United Kingdom	4.19	3.45
Canada	2.58	2.16
Developing countries	17.71	34.38
By region		
Africa	1.72	4.05
Asia	7.29	17.67
Middle East and Europe	4.28	4.46
Western Hemisphere	4.42	8.21
Countries in transition	9.07	11.18
Former Soviet Union[3]	7.53	8.31
Central Europe	1.53	2.85

[1]The exchange-rate-based GDP weights are a three-year moving average for 1987–89; the PPP-based weights are for 1990.
[2]Exchange-rate-based weights for west Germany only; PPP-based weights are for unified Germany.
[3]The exchange-rate-based weights are derived from estimates of approximate PPP exchange rates.

Data: IMF, *World Economic Outlook*, May 1993

From the Executive Board . . .

El Salvador: Stand-By Credit. The IMF has approved a stand-by credit for El Salvador, authorizing drawings up to the equivalent of SDR 34.55 million (about $49 million) over the next ten months to support the Government's financial and economic program for 1993.

After two years of solid progress, El Salvador faced serious challenges in managing its economy during 1992 following a slump in international coffee prices, a drought, and an increase in public expenditure related to the peace accord of January 1992 that ended 12 years of civil war. Although real GDP grew by an estimated 4.5 percent, the fiscal deficit rose considerably, inflation jumped to 20 percent, and the accumulation of international reserves slowed.

The Government's economic program for 1993 aims at reducing inflation to 12 percent and strengthening the balance of payments while maintaining real GDP growth of about 4.5 percent. The program also aims to consolidate structural reforms, to expand social programs, and to increase public outlays under El Salvador's National Reconstruction Plan from 1 percent of GDP in 1992 to 3 percent in 1993.

The fiscal effort is the centerpiece of the program. An improvement in the savings performance of the nonfinancial public sector is expected to result in a reduction of its overall deficit from 4 percent of GDP in 1992 to 3 percent in 1993, including the operations of the National Reconstruction Plan. Tax revenues are projected to rise, reflecting the full-year effect of the introduction of a value-added tax (VAT) in September 1992, the implementation of a tax package introduced in April 1993, and collection of tax arrears.

On the expenditure side, the program provides for a reduction in central government outlays that includes a decline in military expenditures to 11 percent of budget expenditure from 15 percent, and an increase in health and education outlays to 24 percent of budget expenditure from 19 percent. Monetary policy will rely on credit restraint and continued interest rate flexibility to attain the program's balance of payments and inflation objectives. Exchange rate policy will continue to be flexible and will aim at maintaining El Salvador's export competitiveness.

The structural reform program focuses on three main areas: public sector modernization through sustainable tax reform and a streamlining of the civil service; financial restructuring through the rationalization of public expenditure management and the unification of the ordinary and extraordinary budgets; and the restructuring and privatization of the remaining state-owned commercial and savings banks, as well as an accelerated effort to divest the few remaining nonfinancial state enterprises.

The Government's social strategy focuses on providing temporary employment, income, and food supplements, and expanding social services. Social Investment Fund resources are being increased from $30 million in 1992 to $82 million in 1993, with multilateral and bilateral external assistance. Special attention is being given to the education and health sectors, improvements in local administration and community participation, and expanding the coverage of all programs to the areas most affected by the civil war. The Government's efforts in this area will be supplemented by social sector loan financed by the World Bank, and significant social expenditures are also being undertaken in the context of the National Reconstruction Plan. El Salvador is an original member of the IMF, and its quota is SDR 125.6 million (about $179 million). It has no outstanding financial obligations to the IMF.

Press Release No. 93/20, May 11

Kyrgyzstan: Systemic Transformation Facility. The International Monetary Fund has approved credits totaling SDR 43.21 million (about $62 million) for Kyrgyzstan to support the Government's 1993 economic and financial program, including the introduction of the national currency, the som. Of this, SDR 16.125 million will be provided under the IMF's new systemic transformation facility (STF). Kyrgyzstan is the first member of the IMF to use the STF, which was established on April 23, 1993 (see Press Release No. 93/17). A second, equal-sized, disbursement under this facility is potentially available to Kyrgyzstan after the completion of the first review under the stand-by arrangement, scheduled for September 1993. A further SDR 27.09 million (about $39 million) is available over the next 11 months under a stand-by credit. This is the first use of IMF financing by Kyrgyzstan, which joined the IMF on May 8, 1992. Its quota in the IMF is SDR 64.5 million (about $92 million).

In approving these credits, all Executive Directors strongly supported the far-reaching adjustment efforts of Kyrgyzstan and the introduction of the national currency.

Decades of central planning have left Kyrgyzstan with a distorted economy, an excessively specialized pattern of production, and growing macroeconomic imbalances. In 1991, efforts to maintain trade with the other states of the former Soviet Union largely failed, and severe disruptions in the interrepublican supply network contributed to a decline in real GDP of about 5 percent. These disruptions were exacerbated in 1992 by a sharp increase in the cost of petroleum imports, the further loss or shrinkage of traditional export markets, and an increasingly inefficient payments system within the former Soviet Union. As a result, real GDP is estimated to have declined by a further 25 percent in 1992, led by a sharp drop in industrial production.

SDR Rates

Week Beginning	Rate of Interest and Charges (percent)
May 24	4.65
May 31	4.71

The rate of SDR interest and charges is calculated weekly, by reference to a combined market interest rate, which is the weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket (U.S. dollar, deutsche mark, Japanese yen, French franc, and pound sterling). The interest rates used are those that prevail each Friday. For the latest weekly rates call (202) 623-7171.

Data: IMF Treasurer's Department

During 1992, Kyrgyzstan initiated a number of important structural reforms aimed at reducing and redefining the role of government in the economy by relying increasingly on market forces and integrating Kyrgyzstan more fully into the global trade and payments system. By the end of 1992, most retail trade had been privatized, price controls on most goods had been removed, and the number of government ministries and agencies had been significantly reduced. The authorities recognize, however, that, because of an adverse external environment and the loss of large budgetary transfers and investments from the former Soviet Union, further measures will be needed to ensure that the transformation is successfully completed and the stage set for sustainable growth.

The program for 1993 aims to limit the decline in real GDP to less than 17 percent, sharply reduce the monthly rate of inflation to low single digits by December 1993, and improve Kyrgyzstan's international reserve position. The introduction of the national currency, which began on May 10, will allow Kyrgyzstan to pursue independent macroeconomic policies consistent with the objective of early stabilization. To this end, budgetary discipline will be reimposed following slippages that occurred in the second half of 1992; the existing tax base will be broadened and new revenue sources mobilized; and monetary and credit policies will be tightened to be consistent with the targeted reduction in inflation and to safeguard the internal and external value of the new national currency.

In the structural area, a legal framework for commercial activity will be implemented; privatization will be accelerated and state orders eliminated; price liberalization will be completed; and reform of the banking sector will be pursued. In the external sector, the exchange and trade system was liberalized with the introduction of the som, and a freely floating unified exchange rate regime was introduced.

Under the program, the authorities will rely on a streamlined social safety net to protect the most vulnerable groups, including through targeted transfers to low-income groups to compensate for price increases.

In addition to the credits from the IMF that were approved today, Kyrgyzstan's reform and stabilization program has received indications of strong financial support from the international community.

Press Release No. 93/21, May 13

Stand-By, Extended, Structural Adjustment Facility (SAF), and Enhanced Structural Adjustment Facility (ESAF) Arrangements as of April 30, 1993

(million SDRs)

Member	Date of Arrangement	Expiration Date	Amount Agreed	Undrawn Balance
Stand-by arrangements			**4,490.14**	**2,830.18**
Albania	August 26, 1992	August 25, 1993	20.00	6.88
Barbados	February 7, 1992	May 31, 1993	23.89	9.22
Brazil	January 29, 1992	August 31, 1993	1,500.00	1,372.50
Costa Rica	April 19, 1993	February 18, 1994	21.04	21.04
Czech Republic	March 17, 1993	March 16, 1994	177.00	107.00
Egypt	May 17, 1991	May 31, 1993	234.40	87.20
Estonia	September 16, 1992	September 15, 1993	27.90	15.11
Guatemala	December 18, 1992	March 17, 1994	54.00	54.00
India	October 31, 1991	June 30, 1993	1,656.00	231.00
Jordan	February 26,1992	August 25, 1993	44.40	11.10
Latvia	September 14, 1992	September 13, 1993	54.90	19.83
Lithuania	October 21, 1992	September 20, 1993	56.93	28.45
Panama	February 24, 1992	December 23, 1993	93.88	58.83
Poland	March 8, 1993	March 7, 1994	476.00	476.00
Uruguay	July 1, 1992	June 30, 1993	50.00	34.03
Extended arrangements			**8,588.59**	**2,783.97**
Argentina	March 31, 1992	March 30, 1995	2,483.15	1,182.16
Hungary	February 20, 1991	February 19, 1994	1,114.00	556.77
Jamaica	December 11, 1992	December 10, 1995	100.13	100.13
Mexico	May 26, 1989	May 25, 1993	3,729.60	466.20
Peru	March 18, 1993	March 17, 1996	1,018.10	375.41
Zimbabwe	September 11, 1992	September 10, 1995	114.60	83.30
SAF arrangements			**83.23**	**59.45**
Comoros	June 21, 1991	June 20, 1994	3.15	2.25
Ethiopia	October 28, 1992	October 27, 1995	49.42	35.30
Rwanda	April 24, 1991	April 23, 1994	30.66	21.90
ESAF arrangements			**2,137.37**	**779.79**
Bangladesh	August 10, 1990	September 13, 1993	345.00	–
Benin	January 25, 1993	January 24, 1996	46.95	39.12
Bolivia	July 27, 1988	September 10, 1993	163.26	13.61
Burkina Faso	March 31, 1993	March 30, 1996	48.62	39.78
Burundi	November 13, 1991	November 12, 1994	42.70	23.49
Equatorial Guinea	February 3, 1993	February 2, 1996	12.88	10.12
Guinea	November 6, 1991	November 5, 1994	57.90	40.53
Guyana	July 13, 1990	December 20, 1993	81.52	8.86
Honduras	July 24, 1992	July 23, 1995	40.68	33.90
Lesotho	May 22, 1991	May 21, 1994	18.12	7.55
Malawi	July 15, 1988	May 31, 1993	66.96	5.58
Mali	August 28, 1992	August 27, 1995	60.96	50.80
Mauritania	December 9, 1992	December 8, 1994	33.90	25.43
Mozambique	June 1, 1990	September 30, 1993	100.65	15.25
Nepal	October 5, 1992	October 4, 1995	33.57	27.96
Sri Lanka	September 13, 1991	September 12, 1994	336.00	168.00
Tanzania	July 29, 1991	July 28, 1994	181.90	96.30
Togo	May 31, 1989	May 19, 1993	46.08	7.68
Uganda	April 17, 1989	November 24, 1993	219.12	19.92
Zimbabwe	September 11, 1992	September 10, 1995	200.60	145.90
TOTAL			**15,279.32**	**6,133.39**

Note: Figures may not add to totals because of rounding.

Data: IMF Treasurer's Department

SELECTED TOPICS

Twin Challenges Confront Economies in Transition in Eastern Europe

Several years after beginning their economic reforms, the previously centrally planned economies (PCPEs) of Eastern Europe are still trying to erase the legacy of decades of central planning. Initial sharp declines in output and real earnings and, in some countries, an increased volatility in financial aggregates have exacerbated uncertainty as to the structural changes they need to implement. *Financial Sector Reforms and Exchange Arrangements in Eastern Europe*, a recently published two-part IMF Occasional Paper, surveys the reform experiences of five Eastern European countries—Bulgaria, the former Czechoslovakia, Hungary, Poland, and Romania—through early 1992 and examines two of the key challenges facing them: how to develop efficient financial markets and what type of exchange arrangement to adopt.

Part I of the paper, "Financial Markets and Intermediation" by Guillermo Calvo and Manmohan Kumar of the IMF Research Department, links the success of the stabilization policies and structural reforms being implemented by the PCPEs with the development of efficient financial intermediaries and of credit and capital markets. These economies face the challenge not simply of liberalizing a repressed financial system but of reforming, or creating from scratch, the institutions needed to support a market-oriented system. How well they succeed will be determined, in part, the paper suggests, by how efficiently their financial markets are able to channel savings into the vital and massive restructuring of the productive sectors.

The Banking Sector

In examining recent economic developments in the Eastern European countries, the paper notes that the sharp declines in output and real earnings may have been due in part to problems in the financial sector. At the root of these problems are the weaknesses inherent in the banking sector. Although all five countries surveyed have abandoned the "monobank" system, under which the central bank dominated the financial sector, in favor of a "two-tier" system, under which central banking and commercial banking operations are separate, the bulk of financial intermediation is undertaken by state-owned commercial banks.

Despite the diverse structure of the financial sectors across the PCPEs, their banks have a number of features in common, the most important being the poor quality of their loan portfolios, which, the authors assert, threatens the entire reform process. Whereas, under central planning, the financial flows of the household and enterprise sectors were separate, when commercial banks were created, their asset portfolios consisted almost entirely of enterprise loans. Because of the administrative allocation of financial resources and soft budget constraints, enterprises had been allowed to service outstanding loans through additional borrowing. In Bulgaria, for instance, nonperforming loans at the end of 1991 exceeded 40 percent of total portfolio, while, in Czechoslovakia and Hungary, 15–20 percent of loans were regarded as unserviceable.

What are the consequences of the poor quality of loan portfolios? According to the authors,

- the willingness of banks to recognize loans as nonperforming will be limited, thereby encouraging continued lending to weak enterprises;
- because of credit ceilings and high interest rates, the investment and output of profitable enterprises may decline—banks have tended to make loans to keep unprofitable enterprises afloat, rather than allowing others, which are potentially profitable at world prices, to expand operations; and
- privatization of banks is delayed because it is difficult to attract private, especially foreign, investors who are interested in purchasing the banks outright or in equity participation.

Of the possible approaches they list for restructuring loan portfolios, the authors single out cleaning bank balance sheets by replacing nonperforming loans with interest-bearing government debt, or some type of monetary reform, whereby both the nominal assets and liabilities of banks in relation to enterprises are written off. They point out, however, that both approaches share two related problems. First, the perception that banks are being bailed out could undermine confidence in the transition. Second, without a commitment to the hard budget constraint and without proper incentives, a "onetime cleaning of banks' loan portfolios would be, at best, a temporary measure."

The banking sector, the paper notes, cannot be reformed independently of the enterprise sector, which "will need

to be restructured radically or privatized before banks can undertake market-oriented decisions and begin to channel credit to the most productive sectors." As well as lacking the experience to assess the creditworthiness of enterprises, banks lack the proper enterprise accounts on which to base their assessments. Enterprises, moreover, are cushioned from market forces by soft budget constraints. "It is therefore essential," Calvo and Kumar conclude, "to introduce private ownership to put the appropriate constraints, and the incentive structure, in place."

Furthermore, the authors suggest, developing transparent rules for supervising and monitoring banks and clear guidelines on the role of the central bank could reduce the barriers to entry and spur domestic and foreign competition.

Privatization and Capital Markets

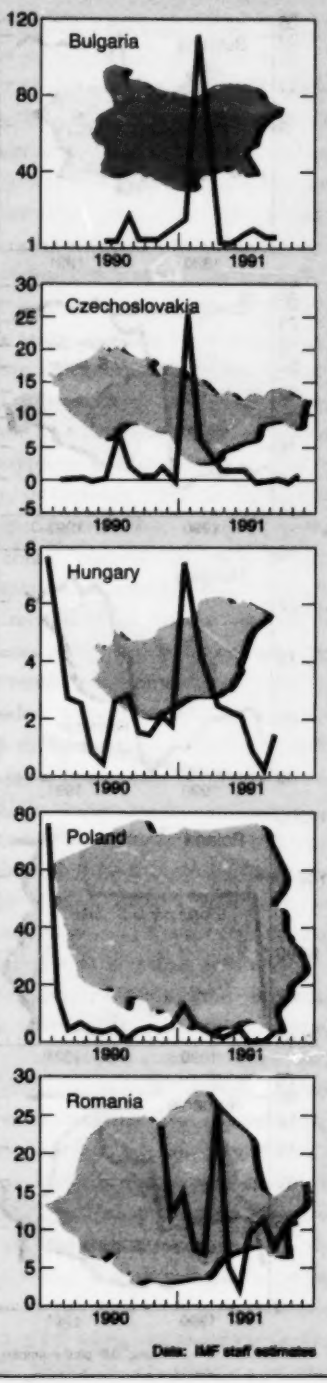
Beset as they are with serious systemic problems that have largely resisted early attempts at reform, the banks, the authors argue, have a limited role to play in privatization. Restructuring enterprises would require that many banks close down. Moreover, as both owners and creditors, banks could face a serious conflict of interest.

Capital markets, on the other hand, especially equity markets, would "yield substantial benefits by mobilizing and channeling risk capital while also reducing its cost." But how quickly can they be developed given time and resource constrains? The authors note that, in many developing countries, notably Korea and India, equity markets have grown extremely rapidly in recent years. Far from viewing the current volatile market environment of the PCPEs as a deterrent to the development of equity markets, Calvo and Kumar claim that, even in the industrial countries, equity markets have tended to play their most important role at the developmental phase. The most significant benefits for the PCPEs, in their view, are the provision of risk capital and the diversification of risks. "Equity markets can finance the risky yet productive borrowers that bankers avoid." They can also provide a mechanism for owners to supervise corporate operations.

Chart 1

Eastern Europe: Inflation Declined Sharply

(monthly percent change)



Data: IMF staff estimates

Financial Sector Reforms and Stabilization Policies

In examining the linkages between financial sector reform and recent monetary policy in the PCPEs, the paper notes that because several countries had intervened to guide banks in setting interest rates on loans and deposits or in limiting loan spreads, deposit and loan rates did not reflect the strength of loan demand, the supply of deposits, or the creditworthiness of the potential borrowers. The PCPEs, the paper concludes, should institute policies to deal with problem loans and parallel reforms of prudential regulations and supervision systems.

Financial reforms also affect monetary policy in that they can produce significant shifts, and hence instability, in the demand for money. Monetary policy needs to take into account the quantitative changes in the structural relationship between the demand for and the supply of money, the paper cautions. Similarly, it points to uncertainties about the monetary policy transmission mechanism, an important aspect of which is the availability of credit. Until the transmission mechanisms are fully developed, the paper cautions, restrictive monetary policies may aggravate output declines.

As regards fiscal policy, the authors single out the financing of deficits as the key issue in the context of financial sector reforms. Bank financing of the much-higher budget deficits that followed the move to market reforms has led to monetary expansion and in-

creased inflation. At the same time, future nonbank financing of fiscal deficits will depend on domestic interest rates, which threaten to be high. However, the paper predicts that as the financial sector broadens and deepens, the financing of government deficits should become more efficient.

Credibility and Prudential Supervision

The destabilizing impact of the reform process is nowhere more apparent than in the banking system, and nowhere is stability more critical. To promote confidence in the system, the authors stress, the PCPEs must straightaway implement banking laws and regulations that establish the ground rules for bank operations and that constrain excessive risk taking. Adequate supervision is also critical in establishing confidence.

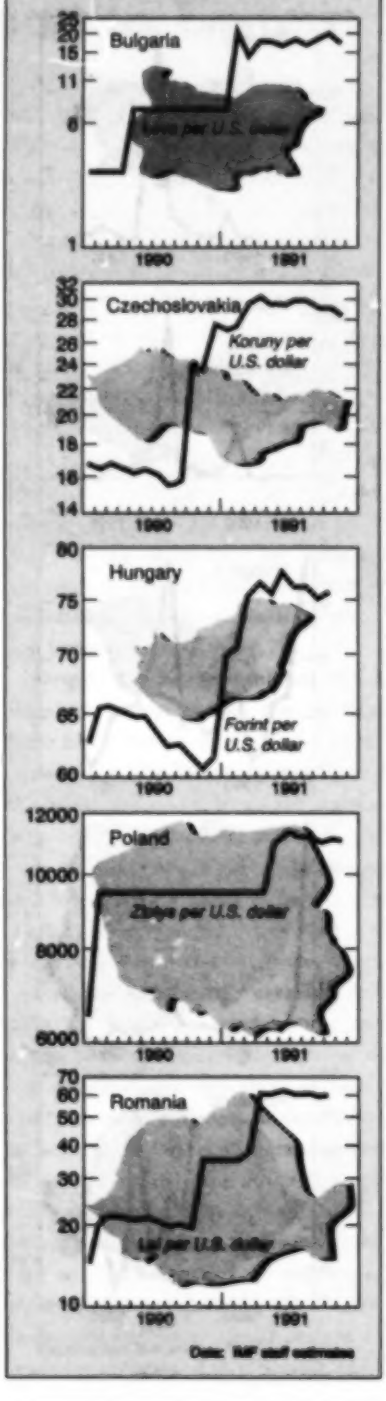
The authors eschew the adoption of explicit deposit protection schemes, which, they assert, "should be considered only after the first lines of defense against banking crises have been established." In the near term, they conclude, the restructuring and adequate capitalization of the banks should take priority.

The International Context

Part I of the Occasional Paper addresses the largely domestic issues related to the development of financial markets in the five PCPEs surveyed. Part II—"Exchange Arrangements of Previously Centrally Planned Economies," written by Eduardo Borensztein of the IMF Research Department and Paul R. Masson of European I Department—puts these economies into the larger context of their integration into the international monetary and trading system.

The PCPEs have inherited seriously distorted price systems and a monopolistic structure in domestic markets. Moreover, having traded very little internationally with market economies, they are hampered by low levels of foreign exchange reserves. It is, therefore, the authors contend, "especially important for them to liberalize their exchange rate systems and to open up their economies to foreign trade in order to import financial discipline, provide competition for domestic producers, and establish an anchor for domestic prices."

Chart 2
Eastern Europe: Exchange Rate Developments
(end of period; log scale)



Data: IMF staff estimates

Currency Convertibility

Current account convertibility—defined as "access to foreign currency for current account purposes"—is, the paper notes, crucial in helping the PCPEs move to world market prices. Moreover, convertibility is a prerequisite for determining the exchange rate in a free market. The paper examines general arguments for convertibility in the PCPEs and the desired speed of the transition before going on to consider the desirable degree of exchange rate flexibility.

One of the strongest arguments for the early introduction of current account convertibility is that it invokes a system of rational relative prices palpably lacking in economies with a legacy of administered prices. Import prices, the authors note, "provide an invaluable guide to rational pricing." However, trade restrictions can interfere with these forces. While convertibility does not demand complete trade liberalization, the authors argue that quantitative restrictions are particularly inimical to competition.

All five of the Eastern European countries surveyed have moved fairly rapidly—and successfully in the authors' view—to current account convertibility. All of them, however, maintain restrictions on capital account convertibility, mainly, the paper notes, because of concern that speculative capital movements might disrupt foreign exchange markets and international trade.

While Borensztein and Masson assert that it is "less imperative" to move to early and unrestricted capital account convertibility, they argue that "ideally current account convertibility should be declared immediately" along with an appropriate exchange rate, adequate foreign reserves, and sound macroeconomic policies.

Most PCPEs adopted current account convertibility with precariously low levels of foreign reserves and little margin to withstand negative balance of payments shocks. However, after convertibility, imports from non-CMEA [Council for Mutual Economic Assistance] countries either declined or more or less equaled the increase in exports to those countries. "It still remains to be seen," the authors observe, "whether, as income recovers and access to international financial markets strengthens, an excessive switch of spending toward imported goods will jeopardize current account convertibility."

Choice of Exchange Arrangement

Inextricably linked to the sustainability of current account convertibility is the choice of exchange arrangement. In examining the desirable degree of exchange rate flexibility, Borensztein and Masson point to the unique problems faced by the PCPEs, among them, the most urgent objective of controlling the price jump that occurs when prices are freed after decades of controls and distortions. They conclude that a fixed exchange rate may provide a useful anchor in the initial stages of liberalization to the extent that it contributes to stabilization and limits the inflationary effects of the price jump. Pegging the exchange rate to a major international currency or basket of currencies allows stable prices to be imported from world markets and therefore removes uncertainty as to the relative price structure and the absolute level of prices that will eventually prevail after controls have been removed. However, the authors point out, even if a country has adequate reserves, uncertainty about the equilibrium level of the real exchange rate makes its choice of the correct level at which to peg difficult; an overdepreciated rate may exacerbate inflationary pressures.

Czechoslovakia and Poland both pegged their exchange rates after substantial depreciations with a view to using the exchange rate as a nominal anchor for prices. In the authors' view, this policy seems to have generally supported domestic price stabilization in these countries. In May 1991, after nearly one and a half years of imposing a pegged rate, Poland depreciated the exchange rate parity in response to a deterioration in its balance of payments position. Just five months later, in October 1991, facing waning competitiveness and a less favorable economic outlook, it reverted to a preannounced crawling peg.

Czechoslovakia, on the other hand, remains committed to a fixed rate with the result that domestic inflation has subsided toward a level comparable with those countries to whose currencies its exchange rate is pegged. However, the authors suggest that it may be premature to contrast the experiences of the two countries since Czechoslovakia implemented current account convertibility at a fixed exchange rate exactly a year later than did Poland.

Bulgaria, Hungary, and Romania have successfully adopted more flexible exchange rate systems despite their rudimentary financial sectors, according to the authors. The adjustable peg system adopted by Hungary allows it to adjust the exchange rate unexpectedly—it has been devalued twice to defend the competitiveness of the forint—and reflects Hungary's greater concern for balance of payments considerations. Hungary, the paper notes, could afford to liberalize its market more gradually because, with about 50 percent of domestic prices already freed by 1988, it did not face the same degree of market disequilibria as did Poland or even Czechoslovakia. Under the adjustable peg system, its exports to the traditional convertible currency area grew by more than 40 percent during 1990 and 1991 (in current dollars), debt rescheduling has been avoided, and access to private international financial markets has been maintained. Inflation, however, remained slightly above an annual rate of 30 percent in 1990–91 (see Chart 1). The floating exchange rates adopted by Bulgaria, and Romania after it abandoned a dual exchange rate system in November 1991, the paper notes, have not generated excessive volatility (see Chart 2).

The experiences of Czechoslovakia and Poland suggest, according to the authors, that a pegged exchange rate regime "can be credible and can contribute to domestic price stabilization in the initial phase of price liberalization." However, they conclude, once stability is attained, other considerations that require exchange rate flexibility may become more important. Moreover, they argue, while reform of fiscal and monetary policy and restructuring of enterprises are indispensable to the functioning of the economy under any exchange rate system, "prolonged maintenance of a fixed peg does generally impose more stringent requirements on financial policies."

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Copies of *Financial Sector Reforms and Exchange Arrangements in Eastern Europe*, which is No. 102 in the IMF's Occasional Paper series, are available for US$15.00 (US$12.00 for full-time college or university students and faculty members) from Publication Services, Box S-372, International Monetary Fund, Washington, D.C. 20431, U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201.

Liberalization and the Role of the State Highlighted at World Bank Conference

The emerging consensus on development favors private sector initiative, reduced government presence, and surrender to market forces. But, according to I. G. Patel, former director of the London School of Economics and Political Science and keynote speaker at the World Bank's Annual Conference on Development Economics, no matter how widely accepted the consensus, we must never lose sight of the limits that specific circumstances impose on general applications of theory.

The appropriate degree and intensity of the state's presence in the context of general liberalization was a major theme in this year's conference, held in Washington on May 3–4. Other related themes included the role of government in financial markets, the appropriate pace of liberalization in socialist economies, and the energy sector and the environment.

Freeing Financial Markets

The general trend toward reduced government presence in the economic life of a country has coincided with the development of highly sophisticated capital markets. Yet, according to Joseph E. Stiglitz of Stanford University and the U.S. Council of Economic Advisers, financial institutions in all countries have been beset by problems and continue to have to be bailed out by their governments. In the prevailing climate of liberalization, then, what role should the state play in ensuring the solvency and stability of its financial institutions? Stiglitz's thesis was that the state did have a role to play and that various forms of government intervention could be beneficial and even welfare enhancing.

According to Stiglitz, the "impetus for liberalization is not based on a sound economic understanding either of how financial markets work or of the potential scope for government intervention, but on an ideological commitment to markets, grounded in neither economic theory nor fact." Financial markets do not fit comfortably under this blanket commitment, not only because financial markets are more prone to failure than other markets, but also because government regulation can make them function better and also improve the overall performance of the economy. Although critics have blamed recent market debacles on overregulation, Stiglitz said the real problem was deregulation—the collapse of the savings and loan associations in the United States for example—and the solution was better designed regulation.

Stiglitz: the problem is not the presence of regulations but their design.

According to Stiglitz, financial markets play a much wider role than the one traditionally ascribed to them, particularly in the developing countries—mobilizing savings and lending them out as investment for industrialization. Capital markets, in effect, "entail the allocation of resources," and serve as the "'brain' of the entire economic system." If they do not perform this function well, the performance of the entire economic system could be affected. And how well they do perform is based on how well they carry out their other related functions—transferring, sharing, and pooling risks and producing, disseminating, and using information.

In economic theory, competitive markets are efficient because information is perfect; that is, information cannot be altered by individual actions taken by participants in the market. In reality, however, information is not perfect, and certainly not in markets where risk is an integral element, as in financial markets. Information about the solvency of financial institutions, for example, is of considerable value to potential investors. However, if efforts to monitor the solvency of institutions are limited, some institutions that are not being monitored may be tempted to undertake risky actions. Investors, for their part, may shy away from a market whose institutions are not being sufficiently monitored; as a result, fewer of the resources that society needs will be allocated through these institutions.

Disruptions to the financial system, which Stiglitz characterized as "ubiquitous and frequent events," have serious and extensive macroeconomic consequences. In his view, these consequences provide the major rationale for government intervention. This rationale is actually an imperative, since a potential consequence of financial disruptions is the possibility of economic collapse: "governments cannot sit idly by when faced with an impending collapse of one or more of the major financial institutions; they almost all engage in

some kind of rescue." This imperative makes the government perforce an insurer and gives rise to problems of moral hazard—if institutions can count on being bailed out, they may be less inclined to behave prudentially.

Stiglitz suggested that the moral hazard problem can be handled in the same way that insurance companies handle it—by imposing restrictions on the insured. What importantly distinguishes the government from a private insurer, however, is that the government cannot refuse to commit itself to provide insurance, and the beneficiaries of the insurance cannot commit themselves to refrain from asking for a bailout.

According to Stiglitz, government intervention in financial markets can take several forms. For developing countries, the most important action has been the creation of financial institutions that can provide funds for long-term investment. Government intervention can also be seen as pursuing "social" objectives, such as ensuring competition, directing resource allocation, and stimulating growth.

Government regulation of financial markets is a public policy issue, and, Stiglitz maintained, "the essential problem of public policy is ascertaining those situations, those forms of intervention, where the strengths of government can most directly be brought to bear, to improve the workings of the market." Therefore, the principles governing financial market regulation should be based both on the government's strengths and on its limitations compared with the private sector.

In particular, the government, through its powers of compulsion and proscription, can "do things that the private sector cannot." While conceding that the circumstances and requirements of individual countries will dictate the most appropriate regulatory structure, Stiglitz said that regulations should generally be based on the recognition that "monitoring banks is costly and necessarily imperfect; and monitoring agencies face severe information problems." These regulatory problems argue "strongly for simple regulatory structures, leaving relatively little scope for discretion."

Stiglitz extended his analysis of government intervention to include financial repression, which, he argued, had merit, despite the prevailing bias against it. For the last 25 years, governments of developing countries have routinely been told to avoid financial repression because, since low interest rates reduce savings, capital accumulation—"a central engine of economic growth"—atrophies, inhibiting economic growth. However, studies of savings have been unable to find much of a relationship between national savings and interest rates, suggesting that the argument "that financial repression depresses the savings rate is at best suspect."

McKinnon: China's gradual approach provides valuable lessons.

Stiglitz supported his case for small financial repressions by citing examples of successful applications in Japan, the Republic of Korea, and Taiwan Province of China.

What, finally, is the government's incentive to intervene if the private sector lacks incentives and resources to monitor itself? According to Stiglitz, macroeconomic instability is a major cause of defaults, and "making sure that government bears some of the consequences may provide it with greater incentives for stabilizing the economy. By the same token, making sure that the government bears some of the consequences for failed institutions provides it with greater incentives to monitor them effectively."

Liberalization—Gradual or "Big Bang"

For the formerly centrally planned economies of Eastern Europe and the former Soviet Union, liberalization has become a necessity. Although the objective of liberalization is clear—to achieve output growth while maintaining price stability—what the appropriate pace of liberalization should be is still an open question. According to Ronald I. McKinnon of Stanford University, who compared the economic liberalization undertaken by China in the late 1970s with that undertaken by the former Soviet Union in the late 1980s and early 1990s, the gradualist approach adopted by China provides valuable lessons for those Eastern European countries that opted instead for the "big bang" approach.

As McKinnon pointed out, from 1989 through 1992, the rapid liberalizations undertaken by Russia (before and after the dissolution of the Soviet Union) as well as by most of the other Eastern European countries have been associated in virtually all cases with sharp decreases in output accompanied by high, often explosive, inflation. In contrast, output in China rose sharply after 1978, and throughout the early 1980s, inflation remained low.

Building on its large agrarian population, China embarked on liberalization in 1978 by breaking up the traditional agricultural communes. Within four or five years, farm output was growing at the rate of 8–10 percent a year. Improved cash positions meant farmers could finance their on-farm investments without borrowing from the state banking system; a severe constraint on lend-

ing to farmers guaranteed a voluntary buildup of savings deposits by rural households. "More by accident than design," said McKinnon, "farmers became big net lenders to the government through the state banking system."

With the focus shifting in 1984 to rural light industry, the labor force released by the improvements in agricultural productivity was quickly absorbed into "hundreds and thousands" of newly created township and village manufacturing enterprises. These enterprises, driven by market forces and "outside the web of official price and output controls" contributed to the already sharp buildup in rural income.

Liberalization of foreign trade was also gradual. Rather than throwing open the whole economy to international competition, the Chinese set up special economic zones that operated outside the state trading monopolies.

The success of the Chinese liberalization must have been evident by 1989. Why, then, McKinnon asked, when the move to more market-based economies became a necessity, "did the Eastern Europeans in general, and Russia in particular, attempt more of a 'big-bang' approach?" It is true, he said, that reform governments had to contend with political and economic circumstances that not only differed markedly from those in China, but that "were largely beyond their economic control." For one thing, the Eastern European countries, which were more industrialized than China, lacked a large agrarian sector that could be liberalized as a first step and begin to generate immediate increases

Currency Units per SDR

Currency	APRIL 20	21	22	23	26	27	28	29	30	MAY 3
Deutsche mark	2.2537	2.26676	2.26833	2.26282	2.24472	2.24688	2.25821	2.24504	2.24824	2.2568
French franc	7.62832	7.65006	7.66534	7.64532	7.57767	7.58521	7.60004	7.5547	7.57386	7.61060
Japanese yen	157.012	155.885	158.137	156.522	157.858	157.763	158.547	...	158.21	...
Pound sterling	0.914854	0.918012	0.918588	0.909585	0.897576	0.896081	0.903831	0.903256	0.904027	...
U.S. dollar	1.42088	1.41328	1.417	1.41777	1.42921	1.42837	1.41666	1.42019	1.42339	1.42175
Argentine peso	...	...	...	...	...	...	...	...	1.41485	...
Australian dollar	1.97179	1.97165	1.98467	1.98433	1.99249	1.98247	1.98635	1.98381	2.00027	2.01011
Austrian schilling	15.8659	15.9404	15.9626	15.8904	15.7813	15.8363	15.8646	15.8067	15.8167	15.8652
Bahrain dinar	0.534025	0.531393	0.532782	0.533082	0.537383	0.537067	0.532739	0.533691	0.535195	0.534578
Bangladesh taka	55.3909	55.1179	55.283	55.293	56.8626	56.8491	56.391	56.5236	56.6509	56.5857
Belgian franc	46.4005	46.5252	46.6406	46.5135	46.1583	46.2983	46.4234	46.1988	46.2915	46.4272
Brazilian cruzeiro	41246.4	...	41708.4	42297.	43207.2	43741.7	43872.3	44864.3	45360.6	45875.6
Canadian dollar	1.76501	1.77782	1.78911	1.78796	1.79795	1.8138	1.80409	1.80677	1.80771	1.80857
Colombian peso	1196.23	1191.	1194.74	1195.93	1208.15	1208.03	1196.91	1200.26	1203.53	1202.77
Danish krone	8.64453	8.66823	8.69117	8.67179	8.60364	8.66449	8.69173	8.6518	8.65848	8.68192
Finnish markka	7.73925	7.80639	7.84366	7.76391	7.68629	7.85578	7.88072	7.88175	7.74822	7.74456
Greek drachma	307.59	308.095	308.865	304.282	305.465	308.343	305.758	304.73	...	308.799
Indian rupee	44.4832	44.2639	44.3804	44.4046	44.8486	44.8508	44.5008	44.523	44.6983	44.5292
Indonesian rupiah	2939.98	2925.49	2934.61	2936.2	2961.32	2959.58	2938.57	2945.47	2952.11	2948.71
Iranian rial	...	...	2329.55	2330.81	2349.62	2348.24	2329.32	2334.79	2340.05	2337.36
Iraqi dinar	0.441504	0.439328	0.440485	0.440724	0.44458	0.444019	0.440441	0.441478	0.442471	0.441981
Irish pound	0.925746	0.929484	0.929119	0.928224	0.919636	0.92272	0.923678	0.919395	0.923482	0.926405
Italian lira	2163.71	2168.01	2165.49	2174.96	2097.48	2091.36	2098.81	2087.96	2104.57	2106.1
Korean won	1130.54	1134.89	1127.37	1126.54	1137.65	1137.13	1127.82	1130.33	1132.88	1131.71
Kuwaiti dinar	0.427163	0.425068	0.426177	...	0.426035	0.426662	0.42588	0.426981	...	0.42666
Libyan dinar	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286	0.414286
Malaysian ringgit	3.65367	3.63568	3.64608	3.64367	3.67121	3.67063	3.64374	3.65117	3.65699	...
Maltese lira	0.52601	0.523205	0.524757	0.523162	0.522467	0.521700	0.520836	0.520369	0.521904	0.522491
Nepalese rupee	70.2613	69.915	70.1132	70.1513	70.7173	70.6757	70.1062	70.271	70.4293	70.334
Netherlands guilder	2.53648	2.5456	2.54706	2.5449	2.52184	2.52779	2.5315	2.51785	...	2.5384
New Zealand dollar	2.61998	2.61235	2.61536	2.62113	2.61952	2.61176	2.60404	2.6092	2.62325	2.628
Norwegian krone	9.5528	9.57568	9.60584	9.58569	9.48424	9.51223	9.53405	9.49328	9.52319	9.54086
Omani rial	0.548098	0.543406	0.544837	0.545133	0.549631	0.549208	0.544783	0.546083	0.547283	0.546983
Pakistan rupee	38.0164	37.829	37.9266	37.9482	38.2554	38.2329	37.9246	38.0139	38.0996	38.0557
Portuguese escudo	208.503	209.175	210.327	210.085	208.379	209.308	209.129	207.958	208.389	208.71
Qatar riyal	5.16982	5.14434	5.15768	5.16088	5.20232	5.19927	5.15737	5.16949	5.18114	5.17517
Saudi Arabian riyal	5.31885	5.29273	5.30667	5.30965	5.35339	5.34985	5.30614	5.31981	5.3306	5.32445
Singapore dollar	2.30114	2.28937	2.29428	2.29324	2.30917	2.30763	2.28985	2.29417	2.29882	2.29513
South African rand	4.49164	4.47796	4.48636	4.47336	4.487	4.48585	4.47515	4.4807	4.49576	4.50834
Spanish peseta	163.219	164.082	164.783	167.58	165.745	166.134	164.852	164.046	164.644	164.681
Sri Lanka rupee	68.1734	67.8374	68.0585	68.0948	68.5449	68.5048	67.9851	68.1549	68.28	68.2158
Swedish krona	...	10.4491	10.5299	10.4397	10.296	10.3035	10.3431	10.3096	10.3881	10.4214
Swiss franc	2.06509	2.06198	2.06526	2.05151	2.02806	2.02757	2.04028	2.03087	2.03146	2.04021
Thai baht	35.7911	35.5894	35.7084	35.6984	35.9589	35.9378	35.719	35.803	35.8984	...
Trinidad and Tobago dollar	6.05128	6.02146	6.03731	6.04059	6.09833	6.09575	6.06871	6.0809	6.18170	...
U.A.E. dirham	5.21385	5.18815	5.20181	5.20483	5.24983	5.24956	5.20129	5.21352	5.23526	5.21884
Venezuelan bolivar	121.079	120.553	121.012	121.191	122.34	122.411	121.587	121.923	122.34	122.199

Notes: 1. The value of U.S. dollar in terms of the SDR is the reciprocal of the sum of the dollar values, based on market exchange rates, of specified quantities of the first five currencies shown. The exchange rates used for this purpose are noon rates in the London foreign exchange market. When the London market is closed, noon rates in the New York market are used. Frankfurt fixing rates are used when the New York market is closed. 2. The value in terms of the SDR of each of the other currencies shown above is derived from that currency's representative exchange rate against the U.S. dollar as reported by the issuing central bank and the SDR value of the U.S. dollar, except for the Iranian rial and the Libyan dinar, the values of which are officially expressed directly in terms of the domestic currency units per SDR.

Data: IMF Treasurer's Department

in output. Also, it was difficult for the various governments to maintain the control necessary for a gradual external and domestic liberalization in the wake of the collapse of the Council for Mutual Economic Assistance, the weakening of domestic centralized authority, and the breakup of the Communist party. Finally, most of the Eastern European economies had to burn off a monetary overhang through a onetime inflation, whereas when China undertook its reform in the late 1970s, there was no evidence of significantly repressed inflation and, hence, no monetary overhang.

In contrast to the Eastern Europe liberalization,China did not liberalize or privatize state-owned industry, mainly, according to McKinnon, because of the "dire social consequences" and economic costs that would follow on the collapse of parts of the "old heavy industrial sector" that were not able to survive decontrol and rationalization. Therefore, the central government "continued to prop up much of state-owned industry by low-cost bank loans and other subsidies." With the soft budget constraints that such subsidization implied and in the absence of competition from a hard budget nonstate sector, McKinnon said the Chinese authorities rightly decided to retain price controls to anchor producer prices. Once the cash-constrained nonstate sector became large enough to compete vigorously with the old state sector in product markets, the Government could relax prices.

The liberalization process in China has not extended to the banking system, mainly because the Government "is leaning on the state banking system as a crutch to cover its own fiscal deficits." According to McKinnon, if the Government were to throw away the crutch, it would be met with an inflationary explosion of the sort that engulfed the former Soviet Union, and the decline in the fiscal position would be neither sustainable nor desirable. "The Chinese Central Government must quickly institute an internal revenue service capable of directly taxing all industries—Central Government, local government, and private—as well as the agricultural sector."

With regard to Russia, McKinnon noted that, while state enterprises were not financially restrained, wage controls kept households cash-constrained. However, the controls did not prevent an inflationary explosion in wholesale prices in the trade among state enterprises in 1992. Thus, as McKinnon pointed out, "as long as the money and credit position of the old state enterprises remains soft, direct price controls in the enterprise sector will remain necessary until a cash-constrained nonstate sector becomes large enough to be an effective competitor."

McKinnon's prescription for "getting the inflation genie back into the bottle" was a major recentralization of the Government's control over money and credit; a reassertion of the primacy of the state-controlled banking system; and recentralization of producer price setting—including the exchange rate. Finally, as with the Chinese, a drastic improvement in the Government's ability to collect tax revenue is necessary for macroeconomic stabilization and for sustaining the longer-term, market-oriented and institutional reforms.

Issues relating to climate have virtually disappeared from the literature on economic development

The Climate and Economic Development

According to William D. Nordhaus of Yale University, the complicated relationship between growth, development, and the environment has added to the long agenda of developmental problems a host of potential problems caused by the harm we are doing to "our natural environment through a multitude of interventions." Nordhaus, who spoke on the relationships between economic development and "climates present" and between economic prospects and "climates future," said the issue of climate change had to be seen in the context of the history of economic development. Until this century, he said, climate has been perceived as an important determinant of a nation's character and development. For example, Ellsworth Huntington, an eminent geographer, wrote in 1915: "The climate of many countries seems to be one of the great reasons why idleness, dishonesty, immorality, stupidity, and weakness of will prevail." However, since the middle of the twentieth century, Nordhaus maintained, "climate has virtually disappeared from the economic development literature." Huntington's "climatic hypothesis of civilization" has been replaced by what Nordhaus suggested should be called the "adaptive theory of climatic impact," which holds "that in the very long run, humans are essentially nomadic toolmakers."

What the adaptive theory is really saying is that humans are capable of thriving in any climate once they have

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adapted to it, and, over the long run, climate has little effect on economic performance or success. However, recent concern about the warming properties of the greenhouse effect has "thrust climate back onto center stage."

Nordhaus's main concern was with the role economists should assume, first, in analyzing the possible size and intensity of the projected climate change; second, in measuring the potential impact; and, third, in finding the most cost-effective measures to offset the impact. In his view, an attempt to base future action on the predictions of climate models was risky: "climate models resemble large macroeconomic models in their ability to answer virtually any question that modelers care to ask; it is not clear that their reliability for forecasting climate change is any better." However, the unreliability of these models is not an argument for doing nothing; rather, policy decisions need to be taken in the context of the "likely impact of projected climate changes."

Unfortunately, as Nordhaus noted, "impact studies are in their infancy, and studies of low-income regions are virtually nonexistent." In the high-income industrialized countries, developments in technology have insulated all but a small fraction of economic activity from "the vagaries of climate." But the developing countries, which have a much heavier concentration in agriculture, would be far more vulnerable to climate change.

The greenhouse effect, said Nordhaus, "is the granddaddy of public goods problems: emissions will affect the global climate globally for centuries to come," but market forces are powerless to ensure that individual economic agents will produce efficient levels of greenhouse gases. If we accept that global warming is inevitable over the next century, then we must come up with the most balanced way to confront this externality. From the perspective of the economist, cost-effectiveness is of key importance: "structuring policies to get the maximal reduction in harmful climatic change for a given level of expenditure."

Nordhaus: policy decisions should take climate changes into account.

But "plain vanilla" cost-benefit analysis may not be broad enough to embrace all eventualities that lie outside the "smooth changes foreseen by climate models." These models cannot foresee catastrophic upsets, nor can they predict unmeasurable effects. "Should we not, then, be ultraconservative and tilt toward preserving the natural world at the expense of economic growth and development? Do we dare put human betterment before the preservation of natural systems? Should we trust that human ingenuity will bail us out should nature deal us a nasty hand?"

These questions, as Nordhaus conceded, may be ultimately unanswerable. But the absence of complete information should not rule out what he called "reasoned decision making under uncertainty"—"choosing the action that maximizes the expected value or utility of the outcome."

At the same time, development economists cannot neglect to ask how poorer regions already overburdened with immediate and severe economic worries can be expected to take on the added burden of "a costly climate-change agenda that will produce some ill-defined and conjectural benefit for future generations." In the end, he said, "societies, like people, must be careful in their choice of enemies."

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